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Everything But Arms: Declining agricultural exports from least developed countries

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Report Highlights:
The results of the analysis show that the EBA trade deficit with the EU has grown over the past five years and is much higher with the EU than with the United States. Possible reasons for the findings related to the EU are presented including instability, rules of origin as well as sanitary and phytosanitary regulations and import standards. Other concepts relating to EU trade with the least developed countries such as trade diversion and export subsidies are briefly discussed as well.

Includes PSD Changes: No
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Summary

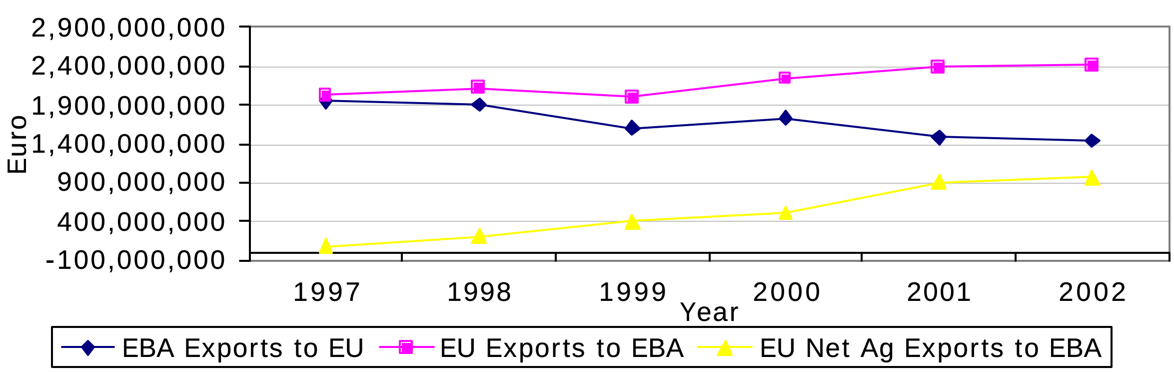
This report focuses on the EU's preferential trade agreement with least developed countries known as Everything But Arms (EBA) that was signed in 2001. The report looks at the EU trade balance with the EBA countries over the last five years and also compares the EBA trade deficit with the EU and the United States. The results of the analysis show that the EBA trade deficit with the EU has grown over the past five years and is much higher with the EU than with the United States. Possible reasons for the findings related to the EU are presented including instability, rules of origin as well as sanitary and phytosanitary regulations and import standards. Other concepts relating to EU trade with the least developed countries such as trade diversion and export subsidies are briefly discussed as well.

Background

The EBA agreement is an extension of the EU's Generalized System of Preferences (GSP) that was added in February of 2001. The unilateral agreement gives the world's 49 least developed countries zero tariffs with no quantitative restrictions on all products, except arms, without reciprocity. The agreement excludes sensitive products including rice, sugar, and bananas, for which there are special provisions for phasing out tariffs rate quotas (TRQs). The 49 least developed countries are those categorized within the United Nations classification scheme as "least developed." The UN uses three criteria: low national income, under $900 GDP per capita; weak human assets; and high economic vulnerability, an index measuring instability of agricultural production and exports, inadequate diversification, and economic smallness. Among the other development indicators, population size is another criteria for being an EBA country. The population limit is 75 million people to be classified as a least developed country, with the exception of Bangladesh. Larger countries with equivalent economic indicators or in some cases lower than many EBA countries do not receive specialized preferences under this system. The UN classification is also the method used for graduation out of the EBA agreement.

The EU preferential market access aspect of the agreement aims to facilitate trade with the least developed countries. The purpose of increased market access is to boost trade in order to help the least developed countries diversify their economies. However, EU agricultural imports from the least developed countries have been decreasing over the past five years; the EBA agricultural trade deficit with the EU reached a new high in 2002 as shown in Table 1.

Figure 1. EU and EBA Agricultural Trade Balance, Euro, 1997 - 2002



Source: Eurostat, 2003

Overall, the EU is a net agricultural importer, however, it is a net exporter to the EBA countries. The primary exports to this region are skim milk powder and wheat. During the 2001/02 marketing year, the EU spend 36.7 million Euros in export subsides on skim milk powder and 8.5 million Euro on wheat. The damage to developing economies by export subsides will be discussed in more detail later in the report. Other main export products include: cigars and cigarettes; beer, wine, and ethanol; malt; and poultry. The EU's net exports to EBA far exceed the net exports from the United States. Overall, the EU partakes in more trade with EBA than does the US, due to proximity to the market and historical ties to its former colonies.

Table 1. EU and US Net Exports with World and Countries Receiving Preferential Treatment, Million Euros, 2002

EU Net Ag Exports 2002		US Net Ag Exports 2002	
World	-924	World	12,730
GSP	-14,359	GSP	4,473
ACP	-4,749	ACP	-1,093
EBA*	***1,115***	***EBA***	***416***

*Main EU exports include: Dairy (0402), wheat (1101), tobacco (2402), 22, 19, 02, 10

Source: Calculated from Eurostat and U.S. Customs, 2003

EBA is a young agreement, the availability of data on trade flows resulting from the agreement are limited to 2001 through March 2003. From the available data, year-to-date comparisons, comparing January through March trade, for 2003 to 2002 and 2001, no proof exists that the EBA agreement has increased trade flows into the EU. A sample of EU countries was taken that includes Denmark, France, Germany, Italy, the Netherlands, Spain, and the UK to determine if imports from the EBA countries have increased or decreased. The Netherlands is the only country from the sample that has increased imports from EBA countries thus far in 2003. In terms of overall EU, data is only available through February 2003 at this time. In making comparisons 2002 and 2003 of January and February trade, EBA exports to the EU have increased by a meager .45 percent. This number is not representative due to aggregation bias of artificially high and low growth rates. Several EBA countries have increased shipments to the EU from a starting of zero, so the percentage increase is not represented accurately. Also in some cases, a country will export one shipment to the EU in 2001 and no shipments in 2002 resulting in a dramatic decrease, although the relative value of the shipment was low in 2001. There is not sufficient evidence to conclude that imports in the EU have increased due to EBA.

Table 2. Sample of EU imports from EBA countries, comparing January through March 2001, 2002, 2003, Million Euro

	January through March Imports			
Country	2001	2002	2003	*% Change*
Denmark	3.7	3.7	2.8	*-24.9*
France	76.3	75.0	74.05	*-1.27*
Germany	104.9	85.9	83.7	*-2.57*
Italy	44.7	40.1	35.5	*-11.37*
Netherlands	59.5	49.8	63.3	*26.97*
Spain	31.2	26.5	24.2	*-8.56*
United Kingdom	39.1	48.7	43.4	*-10.81*

Source: Eurostat, 2003

Why is there no increase in agricultural exports from EBA countries?

The purpose of the EBA agreement, which is to provide increased market access through eliminating tariffs and quotas, has thus far failed to increase EBA exports to the EU. An important aspect of trade flows between EBA and the EU, cited by Paul Brenton in a World Bank study, is that many EBA countries prefer to still use the Cotonou Agreement (ACP preferences) to export to the EU rather than EBA preferences.[1] The World Bank cites other trade barriers, such as rules of origin laws, restrictiveness of the requirements on sufficient processing, and the costs and difficulties of providing the necessary paper work as reasons that EBA countries prefer using the Cotonou agreement and also as reasons why exports to the EU have not increased.[2]

Instability

A main problem with unilateral preferences provided by the European Union in the eyes of the beneficiaries is the possible instability of the agreement. The current GSP, excluding EBA, will be reviewed in 2005, when new proposals on the special preferences will be considered. The preferences under EBA are given an unlimited time period. However, if there are significant increases in imports relative to usual levels, temporary suspension of preferences is an option. No guarantee to developing countries or the least developed countries that their preferences will be maintained is given. In addition, countries that do begin to develop stronger and more diversified economies can be graduated out of the trade preferences portion of the agreement. Currently, Colombia and Costa Rica receive special preferences to help stop drug trafficking in the EU's GSP, but are being graduated due to growth and diversification of exports. The instability of the trade preferences do not provide a friendly atmosphere for foreign investment, an important facet for development and trade enhancement.

In addition to the instability of the preferences, EU standards and import rules are often changed during the course of a few months. The changes in standards and rules are not transparent enough for developing countries, presenting a market failure of asymmetric information. Salvador Namburete, Vice Minister of Industry and Commerce for Mozambique, called the EU standards a "moving target." He then recalled the story of a shrimp exporter who met all standards and import regulations when the ship left the port, but by the time the ship reached the EU the standards had changed and the cargo was not unloaded.[3]

Rules of Origin

Rules of origin are important aspects of trade agreements between developed and developing countries. The theory behind rules of origin is to prevent trade deflection from countries not receiving special preferences through another country receiving preferences and into the final market in order to exploit the trade preferences bestowed to the lesser developed country. In this case, an example would be a developing country such as Thailand shipping rice through Laos to the EU so that it does not pay any tariff on the rice. Rules of origin are meant to encourage further value added within the least developed countries and increase employment and export diversification. However, rules of origin dictated by the developed countries in some trade agreements are too stringent to allow proper sourcing of products and are often too costly to prove.[4]

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[1] Brenton, Paul. "Integrating the Least Developed Countries into the World Trading System: The Current Impact of EU Preferences under Everything But Arms." The World Bank, International Trade Department. World Bank Policy Research Working Paper 3018, April 2003.
[2] *ibid*
[3] Namburete, Salvador. Speech to the European Policy Center, Brussels, July 31, 2003.
[4] Brenton, Paul. "Integrating the Least Developed Countries into the World Trading System: The Current Impact of EU Preferences under Everything But Arms." The World Bank, International Trade Department. World Bank Policy Research Working Paper 3018, April 2003.

Restrictive rules of origin seem to be the primary reason that EBA countries that are also ACP prefer to use the Cotonou Agreement and also as to why exports from the EBA region are not increasing to the EU. The rules of origin restrictions are more restrictive in the EBA agreement than in the Cotonou Agreement. Two aspects of the rules of origin primarily affecting EBA countries will be further discussed: cumulation and substantial processing. In addition, a specific example of more restrictive rules of origin on EBA countries than ACP countries in fishing is given.

Cumulation

The rules of origin in the Cotonou agreement generally, with some exceptions, allow full cumulation within ACP countries.[5] The general rules of origin apply to all ACP states as well as overseas countries and territories (OCT), allowing the products to move within the region for further processing prior to export to the EU. Under full cumulation, products that undergo further processing in ACP countries, although the original goods may not have originated in the ACP region, are still eligible for duty-free access.

The same principle of full cumulation is not extended to the EBA agreement, since EBA is an extension of GSP, rather the concept of diagonal cumulation applies. Products may move within EBA countries for further processing, however, sourcing from outside of EBA, including other ACP countries, is not an option for products to enter the EU duty-free. Three regional exceptions to this are available as listed in the Official Journal.[6]

Diagonal cumulation is more difficult to follow and is also more expensive for the least developed countries to prove. This concept is trade distortive, as it does not allow the least developed countries to source from least cost producers. This is more important in terms of manufactured goods, but is still prevalent in agricultural trade.

In terms of agricultural trade, the EU recently tightened cumulation rules regarding rice and sugar for EBA countries and regional cumulation. The rules were tightened to exclude even the first phases of processing rice and sugar: husking, partial or total milling, polishing and glazing cereals and rice; and operations to color sugar or form sugar lumps, partial or total milling of sugar.[7] At the same time no changes were made to the ACP preferences. This change in cumulation rules has three direct consequences: 1. prevents further processing in LDCs, who would benefit to a great extent from increased processing in the country in terms of employment and export diversification; 2. creates trade diversions, not allowing sourcing from least cost producers; 3. allows the EU to gain access to raw goods, further process them and export value-added.

Substantial Processing

Although rules on what classifies as substantial processing are the same for ACP and EBA, it is still restrictive and does not allow the developing countries to build a food-processing sector and continue to receive duty-free access. In terms of agricultural exports, the only processing allowed to take place in these countries from products not originating within the beneficiary countries are: 1. peeling, stoning and shelling, of fruits, nuts, and vegetables; 2. sifting, screening, sorting, classifying, grading, matching; 3. simple mixing of products; 4. slaughter of animals.[8]

[5] Official Journal of the European Communities, L317/3 December 15, 2000.
[6] Official Journal of the European Communities, L 134/1, May 29, 2003.
[7] *ibid*
[8] *ibid*

Fishing
Ship requirements under the EBA agreement are much more stringent than provided under the Cotonou Agreement in terms of fishing vessels. The differences are outlined below in bullet points.

- Cotonou Agreement
  - The vessel can be registered in the EU or in any ACP country, independent of which country the products are exported from.
  - The vessel can sail under the flag of any ACP country or the EU.
  - The master and officers along with 50 percent of the crew must be nationals of ACP countries or the EU.
- EBA agreement
  - The ship must be registered to the EU or the direct beneficiary country.
  - The vessel must sail under the flag of the EU or the direct beneficiary country.
  - The master and officers along with 75 percent of the crew must be from the beneficiary or the EU.

In the Cotonou agreement, much more flexibility is allowed in the rules of origin for fishing and exporting to the EU within the agreement. A major distinction is the ease to which the majority of ACP countries can meet these requirements. Many EBA countries are landlocked or are too poor to have a significant merchant marine that can meet these requirements. *De facto,* EU ships in particular are required in order for the beneficiary country to export to the EU. The use of EU ships and crew is much more expensive than using flags of convenience due to EU regulatory systems. The tightened rules in the EBA agreement add additional costs to using the preferences afforded.

Sanitary and Phytosanitary Regulations and Import Standards
Sanitary and Phytosanitary (SPS) regulations and import standards are not unique to the EU and EBA agreement, nor are they actually part of any specific agreement, but are a standard applied equally to all countries. The EU does have more burdensome standards, both through voluntary and mandatory standards than many countries.[9] According to John S. Wilson of the World Bank, the "EU is increasingly regulating at a restrictive level, often more restrictive than the CODEX system."[10] The United States and farmers from many other developed countries often have difficulty in meeting the strict standards required for exporting agricultural products. Producers in developed countries have the luxury of technology and other aids that producers in developing countries cannot afford. The problem for the least developed countries is having the capacity to meet these requirements and to be able to provide proof of meeting the standard while still maintaining a comparative advantage.

South Africa, a much more developed country relative to EBA countries, continues to have difficulty meeting EU sanitary and phytosanitary regulations. Recently the EU has tightened the regulations beyond the Codex standard on how much chemical residue can be on citrus when imported, which has put a large burden on South African farmers. Farmers that previously met all EU standards are now unable to export their products to the EU.

Domestic farm programs in developing countries are often unsuccessful, as governments cannot provide incentives to help producers meet these requirements. Producers in

[9] Wilson, John S. and Victor Abiola. "Standards and Global Trade: A Voice for Africa," World Bank, Washington D.C. 2003.
[10] Wilson, John S. Speech to the European Policy Center, Brussels, July 31, 2003.

developing countries cannot find incentive to use these standards when there is no guarantee that they can meet them or that the standards will be not changed. Developing countries often make the case that technical assistance in terms of capacity building to meet SPS standards would be extremely beneficial to increasing agricultural exports.

Trade Diversion
Preferential trade agreements, particularly to higher cost producers can have the effect of introducing distortions to the allocation of resources within the country receiving the preferences. This can result in, at best, a sub-optimal use of scarce resources and can even cause long-term economic problems by starving sectors, which may otherwise receive investment and other resources. Furthermore, preferential trading arrangements can create an artificial comparative advantage due to the duty-free access into the market. For example, many high cost sugar producers are able to sell into the European market only through receiving zero tariff access to the market, they would most-likely not be able to compete in the market without having this advantage. Economic theory suggests that the producer should allocate resources to their most efficient uses, however, the trade diversion created is rather unlikely to lead to the best long-term use of resources for promoting growth through trade. An especially damaging possibility is the reorganizing of the GSP and EBA preferences by the EU to no longer give preferences to the same countries in every sector. There is no guarantee that this will happen, however, it is a distinct possibility as sectors develop and become competitive on the world market.

Another effect of preferential trading arrangements is the exploitation of sectors that do maintain a comparative advantage. A good demonstration of this is the Fiji sugar story. Fiji does have comparative advantage over the EU in terms of sugar production. Fiji is a member of ACP, thus receives zero tariff access into the raw sugar market, thus an even higher comparative advantage. Fiji has re-allocated its resources in the economy to best exploit this one advantage in sugar. However, allocating resources to sugar comes at the expense of allocating these resources away from other crucial sectors. The Fijian economy is entirely based on sugar production and exporting this sugar to the EU, with no incentive to diversify the economy. The economy is dependent on sugar exports to the EU, without the trade preferences provided, it may no longer be able to operate.

Also in terms of trade diversion, the current agreement does not promote export diversification to allow the least developed countries to capture a significant amount of the marketing margin of the supply chain. The largest agricultural export products for EBA countries are un-roasted and un-decaffeinated coffee beans, followed by raw cotton, un-manufactured tobacco, and raw sugar cane. EU manufacturers are able to import raw, un-manufactured goods from the least developed countries with no tariffs. The marketing margin is then captured in the EU where the processing takes place. The EU also captures the gains from trade after exporting the manufactured goods, often back to the developing countries.

Other distortive policies
Export subsidies in cereals, including wheat and rice, wine, and sugar are especially distortive to developing markets. Subsidized EU exports can effectively capture market share due to the lower price that can be accepted, which in turn pushes poorer producers out of the market. This is especially the case in the EU sugar regime in terms of the re-export program where raw sugar is imported, refined, and then exported onto the world market with export subsidies. Due to the subsidies, developing countries are unable to compete with the refined exports of raw products that were originally produced in their country.

The primary EU export to least developed countries are dairy products, particularly condensed milk (HS code 0402). The CAP, largely through export subsidies, heavily supports dairy products in the EU. Direct exports subsidies, like those on dairy, are highly trade distorting, especially to developing economies with many market failures. The export subsidy increases the world's excess supply, causing the price in the importing country to fall while at the same time increasing the price in the exporting country. The falling price in the developing country inhibits market development and also prevents the producers in the domestic market from receiving adequate prices for their products. Developing countries are thus unable to compete on a level playing field. Export subsidies can harm domestic industry in a wide-range of developing countries from the upper tier, such as South Africa to the least developed, such as Sri Lanka. Ravi Karunanayake, Sri Lanka's Trade Minister, told the Wall Street Journal Europe "their [EU] milk program is hindering our dairy industry from getting going."[11] The subsidized milk powder that flows into Sri Lanka is hindering the local governments efforts to develop a domestic dairy industry.

Conclusion
The EU was the first to extend unilateral trade preferences to the least developed countries through the EBA agreement and does engage in more trade with EBA countries than does any other country in the world. The EU is closer in proximity to the EBA countries, literally in terms of distance and figuratively through historical links and former colonial ties. The EBA agreement aims to act as a catalyst for economic growth and stability for the least developed countries through increased market access to the EU. Therefore, it would be expected that the EBA agreement would increase imports into the EU from EBA countries due to duty-free market access. However, EU imports from EBA countries have been decreasing over the past five years and have not shown signs of increase with the EBA agreement. In fact, in 2003, imports from EBA countries are still on the decline in most EU countries relative to 2002 and 2001.

Although the EBA agreement aims to increase exports and export diversification in the least developed countries no sign of increase in agricultural exports to the EU is apparent. Strict rules of origin, as cited by the World Bank, in terms of tight cumulation rules, substantial processing and shipping regulations are one significant cause of the decline in exports to the EU. In terms of export diversification, increased processing occurring in the least developed countries also seems to be prohibited by strict rules of origin, specifically the cumulation rules. Manufacturers are limited to sourcing from other least developed countries, rather than sourcing from least cost producers. Predominately, value added goods are still occurs within the EU, preventing the marketing margin in the supply chain to be captured in the least developed country.

Furthermore, sanitary and phytosanitary regulations and cumbersome import standards can also be largely attributed to the decrease in exports to the EU. Anecdotal evidence from several African countries shows that EU regulations, especially those which surpass the CODEX standard, inhibit exports from developing countries to the EU. John Wilson in a World Bank study noted that a 10 percent increase in EU food standards decreased African exports to the EU by 11 percent.[12]

Compounding the decrease in exports to the EU from EBA countries are other distortive policies that slow growth and diversification in the least developed countries. Notably, export subsidies are extremely harmful to developing agricultural industries, both in domestic and export markets. Also, trade diversions created are harmful to the countries included within EBA as well as those on the outskirts of the agreement. Those within EBA are not guaranteed stability of preferences and must redistribute resource allocation to exploit given comparative advantages. Additionally, countries that are able to adjust easily become

[11] Miller, Scott. "WTO Trade Talks remain Deadlocked Over Concessions." Wall Street Journal. July 15, 2003.
[12] Wilson, John S. Speech to the European Policy Center, Brussels, July 31, 2003.

dependent on the preferences and focus their economy around one product rather than allocating resources throughout the economy.

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